The Management University of Africa

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UNDERGRADUATE UNIVERSITY EXAMINATIONS - DECEMBER 2013

SCHOOL OF MANAGEMENT AND LEADERSHIP

DEGREE OF BACHELOR OF MANAGEMENT AND LEADERSHIP

BML 301: FINANCIAL MANAGEMENT

DATE: 13TH DECEMBER 2013

DURATION: 2 HOURS

MAXIMUM MARKS: 70

INSTRUCTIONS:

1. Write your registration number on the answer booklet.
2. **DO NOT** write on this question paper.
3. This paper contains **SIX (6)** questions.
4. Question ONE is compulsory.
5. Answer any other **TWO** questions.
6. Question one carries **25 MARKS** and the rest carry **15 MARKS** each.
7. **Write all your answers in the Examination answer booklet provided.**

QUESTION ONE

(a) Discuss the drawbacks of using the following approaches in estimating a security's value:

(i) Book value; (3 marks)

(ii) Replacement value; (3 marks)

(iii) Substitution value; (3 marks)

(iv) Intrinsic value. (3 marks)

(b) Ngomongo Holdings Limited has investment interests in three companies. Kirinyaga Video Limited (KVL), Kilgoris Hauliers Limited (KHL) and Turkana Fisheries Limited (TFL). The following financial data relate to these companies.

1. As at 31 December 2001, the financial statements of two of the companies revealed the following information:

Company	**Price of share Sh.**	**Earnings per share Sh.**	**Dividend per share Sh.**
Kirinyaga Video Ltd. (KVL)	160	8	8
Kilgoris Hauliers Ltd. (KHL)	270	18	9

2. Earnings and dividend information for Turkana Fisheries Ltd. (TFL) for the past five years is given below:

Year ended 31 December	**1997**	**1998**	**1999**	**2000**	**2001**
	Sh.	**Sh.**	**Sh.**	**Sh.**	**Sh.**
Earnings per share	5.0	6.0	7.0	10.0	12.0
Dividend per share	3.0	3.0	3.5	5.0	5.5

The estimated return on equity before tax required by investors in Turkana Fisheries Ltd.'s shares is 20%.

REQUIRED:

(i) For Kirinyaga Video Ltd. (KVL) and Kilgoris Hauliers Ltd. (KHL), determine and compare:
   a) Dividend yields (3 marks)
   b) Price/Earnings ratios (3marks)
   c) Dividend covers. (3 marks)

(ii) Using the dividends growth model, determine the market value of 1,000 shares held in Turkana Fisheries Ltd. (TFL) as at 31 December 2001. (4 marks)

QUESTION TWO

Clean Wash Ltd. manufactures and markets automatic washing machines. Among the hundreds of components which it purchases each year from external suppliers for assembling into the finished articles are drive belts, of which it uses 400,000 units per annum. It is considering converting its purchasing, delivery and stock control of this item to a Just-In-Time (JIT) system. This will raise the number of orders placed but lower the administrative and other costs of placing and receiving orders. If successful, this will provide the model for switching most of its inwards supplies into this system.

Details of current and proposed ordering and carrying costs are given below:

	Current	**Proposed**
Ordering cost per order	Sh.10,000	Sh.2,500
Purchase cost per item	Sh.25	Sh.25
Inventory holding cost (as a percentage of the purchase cost)	20%	20%

To implement new arrangements will require a one-off reorganization costs estimated at Sh.140,000 which will be treated as revenue item for tax purposes. The rate of corporation tax is 32.5% and Clean Wash Ltd. can obtain finance at an effective cost of 18%. The life span of the new system is 8 years.

REQUIRED

(a) (i) The economic order quantity with current and proposed arrangements. (5 marks)

(ii) New Present Value (NPV) of the new arrangement. Is the new arrangement worthwhile? (5 marks)

(b) Briefly explain the nature and objectives of JIT purchasing arrangements concluded between components users and suppliers. (5 marks)

QUESTION THREE

(a) Define agency relationship from the context of a public limited company and briefly explain how this arises. (5 marks)

(b) Highlight the various measures that would minimize agency problems between the owners and the management (5 marks)

(c) Evaluate any three factors that may be responsible for the slow growth in the number of companies seeking listing at the Nairobi Stock Exchange or Stock Exchange in your country. (5marks)

QUESTION FOUR

P. Muli was recently appointed to the post of investment manager of Masada Ltd. a quoted company. The company has raised Sh.8,000,000 through a rights issue.

P. Muli has the task of evaluating two mutually exclusive projects with unequal economic lives. Project X has 7 years and Project Y has 4 years of economic life. Both projects are expected to have zero salvage value. Their expected cash flows are as follows:

Project	**X**	**Y**
Year	**Cash flows (Sh.)**	**Cash flows (Sh.)**
1	2,000,000	4,000,000
2	2,200,000	3,000,000
3	2,080,000	4,800,000
4	2,240,000	800,000
5	2,760,000	-
6	3,200,000	-
7	3,600,000	-

The amount raised would be used to finance either of the projects. The company expects to pay a dividend per share of Sh.6.50 in one year's time. The current market price per share is Sh.50. Masada Ltd. expects the future earnings to grow by 7% per annum due to the undertaking of either of the projects. Masada Ltd. has no debt capital in its capital structure.

REQUIRED:

(a) The cost of equity of the firm. (3 marks)

(b) The net present value of each project. (4 marks)

(c) The Internal Rate of return (IRR) of the projects. (Rediscount cash flows at 24% for project X and 25% for Project Y). (4 marks)

(d) Briefly comment on your results in (b) and (c) above. (1 marks)

(e) Identify and explain the circumstances under which the Net Present Value (NPV) and the Internal Rate of Return (IRR) methods could rank mutually exclusive projects in a conflicting way. (3 marks)

QUESTION FIVE

(a) What is meant by the term "capital flight?" (5 marks)

(b) Why have African economies been characterized by much capital flight in the past? (5 marks)

(c) What is the impact of massive capital flight on the value of the domestic currency? (5 marks)

QUESTION SIX

(a) Discuss the main factors which a company should consider when determining the appropriate mix of long-term and short-term debt in its capital structure. (5 marks)

(b) Malindi Leisure Industries is already highly geared by industry standards, but wishes to raise external capital to finance the development of a new beach resort. Outline the arguments for and against a rights issue by Malindi Leisure Industries. (5 marks)

(c) Examine the relative merits of leasing versus hire purchase as a means of acquiring capital assets. (5 marks)